

Recognizing Risk

As we begin the third quarter, we remain optimistic about the fundamental underpinnings of the economy. The small number of earnings warnings by company managements leads us to believe second quarter profits will meet or exceed current expectations. Corporate balance sheets remain healthy and companies continue to operate at very high levels of profitability, generating significant excess cash flows. Save for the housing market and concerns over sub-prime debt, data indicate that the economy, while operating at a slower pace, continues to grow. Government statistics also indicate unemployment levels remain low (4.5%) and income levels continue to increase. Exports remain robust and earnings estimates for large capitalization stocks remain strong. Even the yield curve, which we discuss in detail below, has begun to cooperate in the last month. It would seem the stars remain well aligned for investors.

While we remain constructive on the markets, one ongoing concern we have is investors' lack of sensitivity to incremental risk. For example, investors should expect higher returns from long-term assets (10 year bonds) vs. short-term assets (money market accounts and CDs). This is because uncertainties about getting your money back increase as the time horizon increases; investors typically demand a higher return as compensation to invest in a longer time horizon. For a significant portion of this year the exact opposite was true: short-term rates were higher than long term rates, creating an inverted yield curve. In addition, the difference between the returns

investors were demanding from poor quality (risky) borrowers versus the return demanded from high quality borrowers (the yield spread), was minimal.

Earlier this year we wrote about a similar anomalous phenomenon existing in the equity markets. Generally speaking, larger, more liquid companies with proven long-term track records are considered less risky investments than smaller companies. While smaller companies offer more opportunities for growth, growth creates increased risk for companies. The anomaly comes in as we analyze our data and models. Perversely, since late 2005 investors have continued to demand higher returns to invest in large capitalization companies versus their small capitalization brethren.

The markets did not arrive at this juncture "overnight." Over time, a combination of financial conditions supportive of economic growth, have led us to this point. After peaking in 2000, short-term interest rates declined to low levels, and as discussed above, the premium typically assigned to long-term bonds declined. This created a very attractive borrowing environment, which supported economic growth. A low interest rate environment created a positive environment for stock prices, which have risen steadily since 2003. As an overlay, the dollar has declined, low borrowing default rates have persisted (until recently) and lenders relaxed their lending standards as financial innovation in the debt markets exploded and investors awash with cash searched for returns in a low interest rate

local independent personal accessible
interactive creative local independent personal
knowledgeable thoughtful ethical experienced

environment. As investors searched for return, this all led to a tightening of both consumer and corporate credit spreads and ultimately to an inverted yield curve.

Anomalies occur in markets but they cannot be sustained indefinitely. We cannot always identify the catalyst for the correction yet we know investing in overvalued securities does not generally work in one's favor! This is the reason we shortened the maturities of our bond portfolios earlier in the year and continued to increase exposure to large capitalization companies.

However, it appears that recent events have resulted in bond market investors behaving in a more rational manner. One of the most striking events of the last quarter, (other than the 24/7 media coverage of Paris Hilton) occurred in the latter part of June when concerns over two Bear Stearns hedge funds invested in CDO's (collateralized debt obligations—i.e. sub prime mortgages) emerged. The hedge fund situation brought to the surface concerns that existed in the sub-prime mortgage market. A potential crisis was averted as several large financial institutions stepped in to protect their interests. Bond market investors responded with a quick turnabout, rapidly re-pricing risk as we rapidly moved from the comfortable environment of growth and easy money described above into a more uncertain environment. Intermediate and long-term bond interest rates increased, transitioning the yield curve back to a normal shape (short-term rates below long-term rates, and the spreads between high and low quality

borrowers widening). This provided us an opportunity to step into the bond markets and, where appropriate, purchase intermediate term bonds (5-8 years) with yields above five percent, a level we had not seen in some time.

We note that in the second quarter the equity markets also began to behave more rationally, albeit in a subtle manner, with no identifiable catalyst. Investors continue to demand higher returns from large capitalization stocks than from small capitalization stocks. However, the spread between the two narrowed for the first time in over 15 months. While we don't want to read too much into one month of data we are encouraged by the recent change in direction.

It is unclear as to how this will ultimately play out in the markets, yet early activities were encouraging as the recognition of risk in both the bond and equity markets seemed to occur in a fairly orderly manner. As we noted at the beginning of this piece, we are confident in the underpinnings of the economy at this time. However, as we continue through this year and consider investments for your portfolios we continue to be mindful of the mispricing of risk in the markets, the potential impact that this mispricing can have on investor perceptions, and the investment opportunities created as investor perceptions shift.

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The views in this publication are as of July 2007 and are for informational purposes only. Statements concerning financial market outlook are based on current market conditions, which will fluctuate. Keep in mind that each sector of the market entails risk.

Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.